

Annex I to the Commission Staff Working Paper

THE LEGAL SYSTEMS OF CIVIL LIABILITY OF STATUTORY AUDITORS IN THE EUROPEAN UNION

**Update of the study carried out on behalf of the Commission by Thieffry & Associates
in 2001 –**

Introduction

This current update focuses on the civil liability of statutory auditors referred to the statutory audit carried out for public companies quoted on capital markets¹, as the situation stands in October 2006. This report presents an overview on civil liability systems for auditors and any reforms foreseen; secondly, it also focuses on the potential addressees and claimants of a liability action, as well as on the class action issue. The third part of this report presents the extent of auditor's liability and its limitations, both statutory and contractual. Finally, the report deals with the obligation and conditions of auditor's professional insurance.

1. Overview on the auditor's civil liability systems and reforms

Civil liability systems

16 Member States have adopted a combination of specific rules applying to auditor's liability on top of a general civil liability background². General rules have therefore a gap filling function.

Reforms

In the UK, a draft law allowing contractual limitation of liability is currently discussed. In Estonia, a new draft auditing act is under preparation. The act may possibly include some amendments to the rules on auditor's liability.

2. Parties of an auditor's liability action

2.1 The auditor - the addressee of the claim – distribution of liability

Audit Firm

The appointed statutory auditor, either an individual or a firm, is liable in all the Member States of the European Union. In the majority of Member States, if the auditor is a firm, the

¹ Other services provided by auditors and criminal liability are excluded. The drafting of this report has followed the definitions and, as far as possible, the structure of the study on auditors liability carried out on behalf of the Commission by Thieffry et Associés in 2001

² See table Nr. 1 of the annex II.

individual signing the report or/and the lead engagement partner are jointly and severally liable with the audit firm. In Ireland, only a sole practitioner or a partnership may be appointed as a statutory auditor. In the UK and in Austria, if the firm is the statutory auditor, the firm is liable, and not the lead engagement partner on an assignment. Where the lead engagement partner assumes a separate personal duty of care to the client under the law, he or she can also be liable: but this is rare.

2.2 The damaged party

2.2.1 Audited Company

In all the Member States, the audited company is entitled to bring a claim against the statutory auditor, either by its management or by its liquidators. In the majority of Member States, the liability of the auditor towards the audited company is based on the contract existing between them. Breach of a contractual duty in conjunction with the audit services provided must be proven by the audited company. In a minority of Member States, liability of the auditor towards the audited company can be based on tort. In some countries, shareholders may bring actions against the auditor on behalf of the company (derivative actions³).

2.2.2 Third parties

However, the audited company may not be the only one entitled to sue the auditor⁴. Individual shareholders, creditors and prospective purchasers of the audited company are all in a position to rely on the statutory auditor's report and, as a result, may have suffered damages on their own.

In a majority of Member States, any third party could seek to recover damages from the statutory auditor upon proving the elements of the liability claim, usually fault (intentional conduct or negligence in any degree), recoverable damages and causation (see the example below: France). This causal link between the damage and the fault can however be difficult to establish for the third parties.

In a minority of Member States, actions by third parties are restricted: the statutory auditor has to owe a duty of care to a third party, i.e. the auditor knew or ought reasonably to have known that his work or report would be relied on by claimant for a particular purpose. In practice, for example in the UK, in ordinary circumstances, auditors owe a duty of care only to the members of a company as a body (including shareholders of the company collectively

³ Derivative actions differ from that of shareholders organisations and class actions in that the shareholders bring a suit on behalf of the company for injuries that the company suffered. Any damages awarded are paid to the company.

⁴ See table Nr.2.2 of the annex II

in their capacity as members but not shareholders in their individual capacity: see the example below UK).

The general trend regarding third party actions are to base the liability action on tort, but it can be based on contract and on tort in two Member States (see the example below: Germany). Three different national regimes concerning the third parties claims are presented below:

France

In France, third parties can bring an action in tort against the statutory auditor. The third party needs to demonstrate its damage, the auditor's fault or negligence and the causal link between the fault and the damage. Those general rules of civil liability are supplemented by specific provisions applying to statutory auditors⁵, which specify that statutory auditors cannot be held liable for management's illegal acts, except if, being aware of them, the statutory auditor did not report them to the shareholders or the corporate governance body.

In France, shareholders' organisations have the right to bring an action to recover the damages sustained by each of their members individually. The association cannot proceed in this regard without the written approval of each investor, which makes the action different from class actions. A certified association can also bring a claim in cases involving conduct that caused damages to all investors or to all members of certain categories of investors but, in this case, a damage to the collective interest of all members has to be established.

UK

In UK, the third party must demonstrate that the statutory auditor owes him a duty of care. In *Caparo v. Dickman*⁶, the House of Lords said that, in order for a duty of care to arise, the claimant must prove that (i) it was reasonably foreseeable that damage of the kind allegedly sustained would be suffered if the defendant failed to take reasonable care, (ii) there was sufficient proximity⁷ between the parties and (iii) it would be just, fair and reasonable to impose a duty of care on the defendant. Auditors owe a duty of care, in ordinary circumstances, only to the company's existing shareholders as a body and, even then, only in

⁵ Article L. 822-17 and L. 822-18 Code de Commerce

⁶ [1990] 2 A.C.605

⁷ The House of Lords also laid down what are now generally regarded as the accepted criteria for determining whether or not there is sufficient proximity between an auditor and a non-client party, such as to give rise to a duty of care on the part of the auditor to protect that party from a particular loss. There will only be sufficient proximity where: (i) the work produced was required for a purpose made known to the auditor; and (ii) the auditor knew or should have known that its work product would be communicated to the non-client party for that purpose; and (iii) the auditor knew or should have known that its work would be likely to be acted upon by the non-client party for that purpose, without independent enquiry.

relation to their ability, derived from their existing shareholdings, to exercise rights of stewardship over the company.

Germany

In Germany, the liability against third parties can be based on contract or in tort. Germany's Supreme Court (BGH) ruled that an "information contract" between an auditor and a third party may tacitly be concluded if information was given by the auditor which recognisably was of essential significance to the third party and was a basis for important investment decisions⁸. In addition, contracts with protective effects to third parties may also justify liability by auditor⁹. Third parties may also base their action on general rules of tort liability¹⁰. The Court rejected including into the protection area of the audit contract an unknown number of creditors, shareholders or investors, like in the Caparo case in the UK.

2.3 Class Actions

One of the major litigation risks concerns the possibility to bring class actions like in the US and the difficulty to calculate the risk thereof.

Class actions

Following the classification of the Thieffry study 2001, class actions allow shareholders to join with other shareholders who suffered the same damage to prosecute their claims on behalf of the entire group of shareholders. The notice requirements for potential plaintiffs are usually less formal; targeted shareholders are included in the class unless they expressly request to be excluded.

In Portugal, class actions may be allowed in order to protect investors, but no claim involving an auditor has come before Courts until now. In Spain, class action is regulated by consumers' law and can only be brought by a representative plaintiff on behalf of consumer plaintiffs. On 1 November 2005, the German Capital Markets Model Case Act came into force. This act provides a way to handle capital market mass proceedings in Germany. Moreover, it differs from the US class action: a model case procedure is only available to parties willing to initiate proceedings themselves, be it those of already pending proceedings or those joining later. It

⁸ BGH decision of 17/09/1985

⁹ Under German law a contract may have protective effects with respect to a third party if: the third party is close to the contracting party's performance; the performing party is obliged to provide protection and care, or in his view, the performance shall also be to the benefit of the third party; the benefit to the third party of protection and care must be obvious to the statutory auditor.

¹⁰ In that case the plaintiffs may be within the protective ambit of a breached statute (§ 823 II BGB) or they may be intentionally harmed in a manner that is contrary to "good morals" (§ 826 BGB).

does not allow the raising of a claim in the name of a – more or less unknown – group of plaintiffs.

3. Limitations to liability

3.1 Extent of liability

The auditor's liability arising in the completion of his mission is considered through his duty of care (*obligation de moyens*): no bargained for result is to be achieved but the auditor promises to make every effort possible to achieve the result. In this case, the statutory auditor is liable for his intentional conduct as well as in case of negligence in any degree. As a result, even a slight negligence in the performance of his duties may lead to liability. Since fault or negligence is one of the elements of the cause of action, the auditor may defend by proving the absence of fault or negligence, which usually requires either showing that he acted in accordance with auditing standards or in meeting his duty of care.

As a general rule, statutory auditors are not required to check all the corporate transactions, but to audit the financial statements using a risk approach in order to form their opinion regarding the substantial inaccuracies that could hinder the "true and fair view" qualification of the financial statements. The auditor is a professional of accounting and not a professional of each audited company's activities. As a result, there is a substantial part of judgement in the choice of the audit tests as well as in his opinion.

3.2 Statutory limitations

3.2.1 Time limitations

The limitation period, after the expiry of which claims can no longer be pursued, varies from two to twenty years (after the date of the issuance of the audit report) among Member States¹¹. The least favourable rule to the auditor is the one according to which the limitation period starts to run only upon i) discovery of negligence or ii) discovery of damages or iii) discovery of both damages and the person responsible. In the majority of Member States, the limitation period is interrupted by the defendant's acknowledgement of the plaintiff's claim or by the commencement of legal action. For this reason, even where a long time period is needed in order to settle the claim, it is unlikely that any claim becomes time-barred during a long process.

¹¹ See table Nr. 3.1.1 of the annex II

3.2.2 Liability caps

Auditor's liability is currently capped in five Member States. Liability caps do not apply in case of intentional conduct of the auditor (see table below).

COUNTRY	CALCULATION	AMOUNT OF THE CAP	CONDITIONS
AUSTRIA	Per audit (audits of group accounts and individual accounts being counted separately)	<p>€2 million : statutory audit of a small or medium sized company (§ 221 (2) HGB)</p> <p>€4 million : statutory audit of a large company (§ 221 (3) HGB)</p> <p>€8 million: statutory audit of a company; if the fivefold of one of the size characteristics expressed in Euro of a large company is exceeded</p> <p>€12 million: statutory audit of a company, if the tenfold of one of the size characteristics expressed in Euro of a large company is exceeded</p> <p>Special amounts apply to banks and insurance companies</p>	Scale not applicable to intentional conduct; applicable to claims by the audited company and claims of third parties
BELGIUM	Per mandate	<p>€3 million (unlisted company)</p> <p>€12 million (listed company)</p>	No cap in case of fraud or intentional conduct
GERMANY	Per audit or per group audit	<p>€1 million (unlisted company)</p> <p>€4 million (listed company)</p>	Cap not applicable to intentional conduct;
GREECE	Per breach	Five times the total of the annual emoluments of the President of the Supreme Court or the total of the fees of the liable Certified Auditor in the previous financial year provided that the latter exceeded the former limit	In case of audit firm cap refers to each shareholder or partner separately; cap not applicable to intentional conduct
SLOVENIA	N/A	€50,000	Cap applicable only to audited company and shareholders. In case of intentional tort or gross negligence the court may disregard the cap

3.2.3 Repartition of liability between the auditor and the audited company

The statutory auditor is not the only actor, who may be liable for the loss suffered by the audited company or a third party. The audited company's officers are often also involved and therefore may also be liable for the damage caused to the audited company or third parties. A

statutory auditor is in general not liable for faults committed by the officers of the audited company, but he may be liable for a distinct fault consisting of not detecting the irregularity or fault committed by the management that his auditing work should have allowed him to detect. However, it is necessary to keep in mind that the duties of directors and auditors towards the audited company are not identical. While directors owe a duty of care when drawing up the accounts, auditors are required to follow generally accepted standards of auditing, which do not mandate an examination of each and every accounting procedure of the respective fiscal year. Therefore, some irregularities are permitted to remain undetected with a certain probability, i.e. the company or third parties may suffer damages (ex post) without the auditor having violated his duties (ex ante). If both the directors and the auditors have violated their duties, the question of repartition of liability between them has to be envisaged.

Proportionate / Joint and several liability

Proportionate liability means that, in the case of a claim brought by a third party, when both the auditor and the audited company have contributed to the same damage, the percentage of the damage for which each party is liable has to be determined precisely according to the criteria set by a legal provision or by the judge in a specific case. When the liability is proportionate, each party is solely liable for the portion of the damage that corresponds to the determined percentage and is not obliged to compensate the whole loss to the victim. In general, the main criterion for proportionality applied by a judge to determine the allocation of responsibilities is the degree of fault.

On the other hand, joint and several liability applies when several parties have contributed to the same damage and the victim can bring an action for the whole loss against any of the parties which are responsible for the loss. This implies that even if auditors are only liable for damages resulting from their own fault, if their fault is considered to be a fault without which the full damage would not have occurred, the courts may hold the auditor, as well as director of the audited company, liable to compensate the plaintiff in full. This means that in the event directors are insolvent, the auditor may be held to pay the full damages.

Contributory Negligence

In all the Member States, except Austria, the statutory auditor may raise the audited company's own fault¹² as a defence in a claim brought by the audited company. In this case, damages to be paid by the auditor to the audited company can be reduced according to the degree of fault of the company.

This rule is well developed in France and the subject of numerous Court decisions, as it is an established principle of civil liability that the victim's negligence relieves the defendant of liability. This relief can be total or partial.

In Ireland and the UK, wrongful acts or omissions on the part of the officers or employees of the audited company could in certain circumstances justify a reduction in any award of damages on the basis of contributory negligence. For example, in the UK, if the negligence of the auditor and the company both contribute to the damage, because the company was negligent in its appointment or supervision of the officers, liability may be apportioned between them as the Court thinks just in accordance with the seriousness of their fault and the causal potency of their contributions to the damage.

3.3 Contractual limitations

The statutory auditor and the audited company may agree to include in the audit contract a clause limiting the liability of the auditor in various ways i.e. to suppress some obligations, to shorten the limitation period, to agree upon a liability cap or to agree on a penalty. In a majority of Member States¹³, contractual limitations are not possible, since the parties cannot alter by contract what has been set forth by law for the purpose of protecting the interests of third parties and the public in general.

3.4 Discharge by shareholders

The statutory auditor may be wholly or in part exempted from liability on the basis of shareholders discharge.

In 4 Member States¹⁴, shareholders may discharge statutory auditor from liability to the audited company relating to the performance of his duties after the presentation of the annual report of the board of directors, of the report of the statutory auditor and the approval of the annual accounts. This discharge prohibits shareholders who approved this proposal from

¹² In Austria, such a defence is only possible against the plaintiff who is a third party and not the audited company.

¹³ See table Nr. 3.2 of the annex II.

¹⁴ See table Nr. 3.3 of the annex II.

taking legal action against the auditor on behalf of the audited company on such grounds. A general discharge of auditor's liability does, however, not relieve such persons from liability to third parties. Notwithstanding a general discharge, the statutory auditor may be held liable for wilful misconduct and fraud in the performance of his duties for the company.

4. Insurance

The insurance of auditor's liability in respect to his auditing activity is mandatory in 23 Member States, where either the law or the professional organisations under their mandatory membership rules require the auditor to subscribe to insurance or have a guarantee that he will be able to meet its claims for liability¹⁵. The insurance company can intervene before a court (both in cases where intent or negligence is claimed), as it is a general principle that parties who have an interest in litigation have the right to intervene.

There are Member States where the obligation of insurance rests with the individual auditor, others where it rests with the firm, others where both have to take out an insurance policy and others where a choice exists and finally those where there is no obligation to obtain insurance. As a general rule acquiring an insurance policy is an admission precondition in the professional body and thus is de facto mandatory for every individual auditor. Also in the case of an audit firm, the legal entity has a legal obligation to insure its auditing activities performed by its partners.

5. Annexe II

5.1. Tables

Disclaimer:

Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, the Commission accepts no liability for any actions taken on the basis of its contents

¹⁵ Insurance is not mandatory in Finland and Slovak Republic.